

# Change for the better

What effect has the current environment had on the private equity sector? David Bailey MSI, managing partner, Augustus Fund Administration, gives his verdict

THE CREDIT CRISIS has led to steep declines in the valuations of quoted companies and brought the hedge fund industry crashing down – both in terms of fund redemptions and uncertainty over the sector following the Madoff issues. But what effect has this had on private equity?

## Firms backed by PE create more jobs than publicly quoted companies

Private equity (PE) in all its guises, such as venture capital, buy-out, mezzanine and infrastructure, invests in unquoted assets and companies. Historically, many of the transactions have utilised high volumes of leverage.

Following the events of the past 12 months, many funds are left with assets valued at less than their purchase value. Portfolio companies that have high levels of leverage may now be in breach of their banking covenants. Given the current market conditions, it is almost impossible for a fund to make any investment disposals – and, therefore, make distributions to its investors.

PE investors (ie. pension funds, insurance companies and financial institutions) have seen their quoted and hedge fund portfolios battered by the fall in the markets, meaning liquidity within their portfolios is reduced dramatically and they might be unable to finance future cash calls from their PE investments. All in all, it seems dire. Some may even suggest that PE is dead.

Evolution of private equity  
Despite the problems and issues, however, this is far from the case. Yes, the PE industry is having to change and evolve, but it is

now in a position to make a substantial contribution to the revival of world economies. The asset class raised more than \$320bn of new money in the first half of 2008 alone. In a world where cash is in desperately short supply and banks are unable to, or won't, lend, PE funds will have some cash to invest – but it goes without saying there will be terms and conditions. PE is a long-term investor in its portfolio companies – generally with five-year time horizons. In recent years, value has often been created from financial engineering but the focus has changed in the past 12 months. There is now much more emphasis on operational efficiencies.

PE houses are changing the staffing of their businesses, with the emphasis on the recruitment of operational managers, as opposed to investment bankers. The industry has sometimes been referred to as “the convalescence home of commerce” and there is no doubt whatsoever that there will be many companies requiring assistance as the global recession starts to bite.

In addition, as company valuations fall in line with the markets, there is a general belief that 2009 and 2010 vintage funds will potentially be some of the best-performing funds that the industry has ever seen. While



raising capital for new funds is difficult, it is by no means impossible. Gone are the days when everyone was raising multi-billion funds – but there is a steady flow of funds coming to the market and receiving investor support. There is a trend towards specialisation, whether it is sector, geography or other denominators. Eastern Europe and the Middle East continue to create attractive opportunities, as do the financial, cleantech and infrastructure sectors. There is a steady flow of secondary opportunities from investors who are seeking to divest certain PE holdings from their portfolios. As a consequence, a number of secondary and distressed funds are being raised. As always, the industry is adapting to the new conditions in the marketplace and moving with the times. Not only do investors need PE to be successful, but so do governments. The sector invests across the complete commercial spectrum, from university start-ups to big household names that may have lost their way. During 2007, European PE and venture capital firms invested €73.8bn in roughly 5,200 companies. Of these, 85 per cent of the companies had less than 500 employees. As a result of investments made by the industry in companies between 2000 and 2004, more than one million jobs were created. Despite the criticisms that have been generated against the industry in recent years, it is a proven fact that companies backed by PE create more jobs than publicly quoted companies – something that politicians will need a great deal of in the next few years. Despite these successes, a number of politicians seem to have a grudge against the industry. There have been strong calls for regulatory intervention in both Europe and the US over the past two years. These have declined of late, while there are other more complex political and economic distractions. However, with enormous fraudulent failures taking place elsewhere within the alternative asset class, the politicians will once again turn their minds to regulation to ensure the protection of investors and portfolio employees alike.

#### Responding to its critics

The industry has listened to many of the complaints laid against it in recent years and become more open and transparent (in accordance with the Walker Report in the

UK). While PE took advantage, along with everyone else, of the cheap and easy credit that was being made available to it, its strategies and transactions have not made any great contribution to the position in which the world economy now finds itself. Similarly, there have been no fraudulent or illegal activities taking place within the industry. Despite this, as a result of the activities and actions of others in different financial sectors, the industry could be faced with higher levels of regulation. This is something that could increase costs and reduce efficiency and freedom – potentially lowering fund performance. The PE industry has, like most other sections of the financial markets, enormous challenges to overcome within the next few years. For example, it needs to change its direction towards smaller funds that have less leverage and more emphasis on operational performance. This will require changes in both the strategies and the manpower employed by management groups. However, the investment opportunities for the industry have probably never been better and future investment returns to investors will probably never be higher. The challenge will be for the industry to change and adapt to these new conditions. Some companies will fail and disappear; others will take their place. Overall, the industry is starting to go through massive evolution and PE will emerge as a stronger asset class, providing higher returns to its supportive investors. ■

